

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

CONDENSED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2006

(UNAUDITED)

Condensed Interim Consolidated Financial Statements as at June 30, 2006 (unaudited)

Contents

	<u>Page</u>
Auditors' review letter	2
Condensed Interim Consolidated Financial Statements as at June 30, 2006 (unaudited)	
Condensed Interim Consolidated Balance Sheets	3
Condensed Interim Consolidated Statements of Operations	4
Condensed Interim Statements of Changes in Shareholders' Equity	5
Condensed Interim Consolidated Statements of Cash Flows	6
Notes to the Condensed Interim Consolidated Financial Statements	8



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The Board of Directors of
"Bezeq" - The Israel Telecommunication Corp. Limited

Dear Sirs,

**Re: Review of the Unaudited Condensed Interim Consolidated Financial Statements as
at June 30, 2006**

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter "Company") as at March 31, 2006, as well as the condensed interim consolidated statements of operations, the condensed interim statements of changes in shareholders' equity and the condensed interim consolidated statements of cash flows for the three-month period then ended.

Our review was carried out in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel. The procedures included, inter alia, reading the said financial statements, reading the minutes of meetings of the shareholders and of the Board of Directors and its committees, as well as making inquiries of persons responsible for financial and accounting matters.

Reports of other auditors were furnished to us which relate to the review of the condensed interim financial statements of consolidated subsidiaries, whose assets as at June 30, 2006, constitute approximately 7% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 12% of the total revenues included in the condensed interim consolidated statement of operations for the six-month period then ended and approximately 12% of the total revenues included in the condensed interim consolidated statement of operations for the three-month period then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in which the Company's investments amount to approximately NIS 89 million as at June 30, 2006, and the Company's share in the losses in respect thereof amount to approximately NIS 1,623 thousand and NIS 573 thousand for the three-month and six-month periods then ended.

As the review is limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the interim consolidated financial statements.

Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is the Israeli member firm of KPMG International, a Swiss cooperative.

In the course of our review, including reviewing the reports of other auditors as mentioned above, nothing came to our attention which would indicate the necessity of making material changes to the said interim financial statements in order for them to be in conformity with generally accepted accounting principles and in accordance with the provisions of Section 4 of the Securities Regulations (Periodic and Immediate Reports), 5730-1970.

We draw attention to the uncertainties relating to the following matters, for which the maximum possible exposure is significant:

1. The continuing opening of the communications sector to competition, changes in tariffs and their effect on the Company's financial position and operating results, as described in Note 1.
2. A program for early retirement as described in Note 5.
3. Contingent claims made against the Company and against invested companies, as described in Note 6A.
4. The financial position of a subsidiary as described in Note 4, including the opinion of the Management of the consolidated company, based on updated forecasts and on the alternative business plan, that the prospects of arranging sources of finance required by the consolidated company in the forthcoming year are good.

We also draw attention also to Note 2D. to the financial statements regarding the adjustment by way of restatement of the financial statements as at June 30, 2005 and December 31, 2005 in order to retroactively reflect the amendment of the accounting treatment of the liability of the Company to its retirees, as described in the abovementioned note.

Somekh Chaikin
Certified Public Accountants (Isr.)

August 14, 2006

Condensed Interim Consolidated Balance Sheets as at

Reported amounts

	June 30 2006	June 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	1,256,602	2,119,303	2,158,773
Short-term investments	2,469,726	1,504,507	2,398,525
Trade receivables	2,077,746	2,076,741	2,113,512
Other receivables and debit balances	338,951	377,719	321,507
Inventory	214,846	285,544	220,404
	6,357,871	6,363,814	7,212,721
Materials and spare parts	89,179	142,092	88,881
Broadcasting rights, net	188,996	159,614	154,500
Investments and long-term receivables			
Investments, deposits and debit balances	765,183	924,052	766,840
Investments in investee companies	88,527	65,575	75,467
	853,710	989,627	842,307
Fixed assets			
Cost	31,053,475	35,030,011	30,627,629
Less– accumulated depreciation	21,757,314	24,695,498	20,684,981
	9,296,161	10,334,513	9,942,648
Other assets			
Goodwill	1,693,685	1,746,099	1,699,546
Deferred charges and other assets	368,565	378,479	380,483
Deferred taxes	320,883	407,882	344,786
	2,383,133	2,532,460	2,424,815
	19,169,050	20,522,120	20,665,872

	June 30 2006	June 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current liabilities			
Bank credit	130,967	89,151	75,191
Current maturities of:			
Long-term bank loans	1,047,815	701,102	1,262,583
Debentures	424,660	307,650	527,167
Trade payables	1,162,538	1,262,678	1,400,714
Employee severance benefits	473,170	635,311*	577,878*
Other current liabilities	1,398,858	1,391,540	1,387,955
	4,638,008	4,387,432	5,231,488
Long-term liabilities			
Long-term loans	1,980,027	2,915,511	2,151,960
Debentures	4,919,632	4,756,884	4,903,056
Employee severance benefits	382,042	666,099*	431,427*
Deferred taxes	38,335	–	–
Other long-term liabilities	41,568	30,417	34,081
Loans extended by minority in a subsidiary:			
Loans	1,134,500	1,085,140	1,114,498
Less – minority share in deficit of a consolidated company	(1,134,500)	(1,085,140)	(1,114,498)
	7,361,604	8,368,911	7,520,524
Contingent liabilities (Note 6)			
Shareholders' equity	7,169,438	7,765,777*	7,913,860*
	19,169,050	20,522,120	20,665,872

* Restated, see Note 2D

Dov Weissglas
Chairman of the Board

Yacov Gelbard
Chief Executive Officer

Ron Eilon
Deputy CEO and CFO

Date of approval of the financial statements: August 14, 2006.

The notes to the financial statements are an integral part thereof.

Condensed Interim Consolidated Statements of Operations

Reported amounts

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues (Note 8)	5,645,127	5,500,498	2,825,872	2,727,375	11,098,686
Costs and expenses					
General and operating expenses (Note 9)	3,564,274	3,505,652	1,780,624	1,741,801	7,193,468
Depreciation	1,144,493	1,161,317	572,663	583,810	2,330,711
Royalties to the Government of Israel	89,422	130,171	26,228	64,619	257,429
	4,798,189	4,797,140	2,379,515	2,390,230	9,781,608
Operating income	846,938	703,358	446,357	337,145	1,317,078
Financing expenses, net	186,238	165,079	114,265	110,203	417,309
Earnings after financing expenses	660,700	538,279	332,092	226,942	899,769
Other income, net (Note 10)	31,050	152,742	21,668	65,128	109,386
Earnings before income tax	691,750	691,021	353,760	292,070	1,009,155
Income tax	237,769	259,823	124,267	126,953	429,594
Earnings after income tax	453,981	431,198	229,493	165,117	579,561
Equity in earnings (losses) of affiliates	1,623	(11,167)	573	(7,846)	(12,645)
Minority share in losses (earnings) of subsidiaries	(26)	8,979	–	7,032	8,942
Earnings before the cumulative effect of a change in accounting principle	455,578	429,010	230,066	164,303	575,858
Cumulative effect of a change in accounting principle as at the beginning of the period	–	15,000	–	–	15,000
Net earnings	455,578	444,010	230,066	164,303	590,858
Primary and diluted earnings per NIS 1 par value of common shares (in NIS):					
Earnings before the cumulative effect of a change in accounting principle	0.175	0.165	0.088	0.063	0.222
Cumulative effect of a change in accounting principle	–	0.005	–	–	0.005
Net earnings per share	0.175	0.170	0.088	0.063	0.227

The notes to the financial statements are an integral part thereof.

Condensed Interim Statements of Changes in Shareholders' Equity

Reported amounts

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
NIS thousands						
Six months ended June 30, 2006						
Balance as at December 31, 2005 (audited)	6,309,133	1,623,423	39,010	1,200,000	(1,257,706)*	7,913,860*
Net earnings (unaudited)	–	–	–	–	455,578	455,578
Dividend (unaudited)	–	–	–	(1,200,000)	–	(1,200,000)
Balance as at June 30, 2006 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>39,010</u>	<u>–</u>	<u>(802,128)</u>	<u>7,169,438</u>
Six months ended June 30, 2005						
Balance as at December 31, 2004 (audited)	6,309,133	1,623,423	37,775	–	(648,564)*	7,321,767*
Net earnings (unaudited)	–	–	–	–	444,010	444,010
Balance as at June 30, 2005 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>–</u>	<u>(204,554)*</u>	<u>7,765,777*</u>
Three months ended June 30, 2006						
Balance as at April 1, 2006 (unaudited)	6,309,133	1,623,423	39,010	–	(1,032,194)*	6,939,372*
Net earnings (unaudited)	–	–	–	–	230,066	230,066
Balance as at June 30, 2006 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>39,010</u>	<u>–</u>	<u>(802,128)</u>	<u>7,169,438</u>
Three months ended June 30, 2005						
Balance as at April 1, 2005 (unaudited)	6,309,133	1,623,423	37,775	–	(368,857)*	7,601,474*
Net earnings (unaudited)	–	–	–	–	164,303	164,303
Balance as at June 30, 2005 (unaudited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>37,775</u>	<u>–</u>	<u>(204,554)*</u>	<u>7,765,777*</u>
Year ended December 31, 2005						
Balance as at December 31, 2004 (audited)	6,309,133	1,623,423	37,775	–	(648,564)*	7,321,767*
Net earnings (audited)	–	–	–	–	590,858	590,858
Payment from the State in respect of privatization of the company (audited)	–	–	1,235	–	–	1,235
Dividend proposed for payment (audited)	–	–	–	1,200,000	(1,200,000)	–
Balance as at December 31, 2005 (audited)	<u>6,309,133</u>	<u>1,623,423</u>	<u>39,010</u>	<u>1,200,000</u>	<u>(1,257,706)*</u>	<u>7,913,860*</u>

* Restated, see Note 2D

The notes to the financial statements are an integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows

Reported amounts

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Cash flows from operating activities					
Net earnings	455,578	444,010	230,066	164,303	590,858
Adjustments to reconcile net earnings to net cash flows from operating activities (see A below)	983,833	825,791*	461,413	513,734*	2,127,730
Net cash generated by operating activities	1,439,411	1,269,801*	691,479	678,037*	2,718,588
Cash flows from investing activities					
Investment in fixed assets	(531,941)	(983,580)	(225,806)	(508,072)	(1,694,071)
Proceeds from disposal of fixed assets and sale of operations	23,360	125,540	9,705	112,972	147,810
Investment in long-term deposits and investments	(4,849)	(6,982)	(1,358)	(6,982)	(10,068)
Redemption of long-term deposits and investments	12,884	8,609	9,291	2,291	91,431
Decrease (increase) in short-term investments, net	(75,507)	(190,036)	(44,754)	85,053	(972,260)
Investment in investee companies	(10,853)	(5,746)	(1,362)	(3,118)	(18,836)
Investment in other assets	(40,786)	(39,442)	(24,245)	(15,682)	(91,893)
Net cash used in investing activities	(627,692)	(1,091,637)*	(278,529)	(333,538)*	(2,547,887)
Cash flows from financing activities					
Issue of debentures (after deduction of issue expenses)	-	1,238,236	-	425,941	1,702,265
Repayment of other debentures	(179,056)	(120,307)	(30,088)	(28,704)	(267,332)
Receipt of long-term loans	-	417,500	-	303,000	474,521
Repayment of long-term loans	(390,610)	(1,052,446)	(226,433)	(460,896)	(1,365,578)
Receipt (repayment) of short-term bank credit, net	55,776	1,049	9,470	(14,410)	(12,911)
Dividend paid	(1,200,000)	-	(1,200,000)	-	-
Net cash generated by (used in) financing activities	(1,713,890)	484,032	(1,447,051)	224,931	530,965
Increase (decrease) in cash and cash equivalents	(902,171)	662,196	(1,034,101)	569,430	701,666
Balance of cash and cash equivalents at the beginning of the period	2,158,773	1,457,107	2,290,703	1,549,873	1,457,107
Balance of cash and cash equivalents at the end of the period	1,256,602	2,119,303	1,256,602	2,119,303	2,158,773

* Reclassified

The notes to the financial statements are integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows (Contd.)

Reported amounts

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
A – Adjustments to reconcile net earnings to net cash flows from operating activities					
Revenue and expenses not involving cash flows:					
Depreciation	1,144,493	1,161,317	572,663	583,810	2,330,711
Deferred taxes	32,240	73,750	586	32,891	144,035
Company's equity in (gains) losses of affiliated companies	(1,623)	11,167	(573)	7,846	12,645
Minority share in gains (losses) of a subsidiary	26	(8,979)	–	(7,032)	(8,942)
Decrease in employee severance benefits, net	(154,093)	(115,160)	(132,431)	(89,874)	(407,265)
Gain on disposal of fixed assets	(12,187)	(2,749)	(2,611)	(1,019)	(5,715)
Gain from sale of operations	–	(103,869)	–	(2,009)	(103,869)
Provision for decrease in value of investments	–	4,700	–	4,700	5,868
Erosion (appreciation) and interest on long-term deposits and investments	1,130	13,146	2,859	(8,693)	22,170
Erosion (appreciation) of short-term investments, net	4,306	(26,662)	14,830	(12,286)	(60,396)
Appreciation (erosion) of long-term liabilities:					
Debentures	101,470	(118,415)	35,304	(34,024)	(69,730)
Long-term loans and other liabilities	1,569	76,058	(13,859)	50,569	129,032
Amortization of other assets and deferred expenses	40,652	95,724	18,959	47,788	196,015
Changes in asset and liability items:					
Increase in broadcasting rights	(34,496)	(19,118)	(15,399)	(8,997)	(14,004)
Decrease (increase) in trade receivables	42,254	(14,518)	13,871	(6,248)	(63,298)
Decrease (increase) in other receivables and debit balances	13,185	(23,953)	60,331	5,291	24,600
Decrease (increase) in inventory	7,023	19,103	(4,014)	13,363	75,943
Decrease (increase) in materials and spare parts	(21,462)	(33,816)*	(3,290)	2,119*	24,952
Decrease in trade payables	(199,044)	(169,270)	(33,076)	(26,498)	(112,461)
Increase (decrease) in other current liabilities	10,903	24,318	(59,425)	(38,317)	20,733
Increase (decrease) in deferred revenues	7,487	(16,983)	6,688	354	(13,294)
	983,833	825,791*	461,413	513,734*	2,127,730
B– Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	190,328	72,981	190,328	72,981	124,719
Sale of fixed assets on credit	13,996	–	13,996	–	17,089

* Reclassified

The notes to the financial statements are an integral part thereof.

Notes to the Financial Statements as at June 30, 2006

NOTE 1 – GENERAL

- A.** These interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim periods pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB) and to the provisions of Section 4 of the Securities Regulations (Periodic and immediate reports), 5730-1970.
- B.** These statements should be read in conjunction with the annual financial statements of the Company and its subsidiaries as at December 31, 2005 and for the year then ended, and their accompanying notes (hereinafter – the Annual Reports).
- C.** The Company presents in the notes to the interim financial statements only those significant changes in its business and legal environment that occurred from the date of the latest annual financial statements, published on March 1, 2006, until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the fields of cellular telephone services, international communication services, domestic communication services and multi-channel television services, appear in Note 1 to the Company's annual financial statements as at December 31, 2005. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:

- (1) Further to Note 1C. to the financial statements as at December 31, 2005, concerning a gradual reduction in the percentage of royalties from 3.5% to 3% – on August 9, 2006 the Knesset Finance Committee approved regulations promulgated by the Minister of Communications with the approval of the Finance Minister, for a reduction in the royalty rate for all the licensees who are required to pay royalties, effective from January 1, 2006, by 0.5% each year until the rate reaches 1% per year in 2010. In addition, the Ministry announced that it would work for amendment of the regulations in a way that would grant the Company retroactive exemption commencing January 2004 from the duty to pay royalties in respect of revenues from services which have been opened to competition.

With the approval of the regulations concerning the reduction of royalties by 0.5% from January 1, 2006, the Group's royalty expense will be reduced in the next quarter in respect of the six month period ended June 30 2006, by approximately NIS 19 million.

- (2) Further to Note 1D. to the financial statements as at December 31, 2005, concerning an appeal filed by the Company in 2001 in the Antitrust Court to change the announcement of the Company's monopoly in the basic telephony service (fixed-line domestic telephony) – following the Company's request that the court expedite the hearing of the appeal, the Company agreed, at the proposal of the court (in view of the time elapsed since it was filed together with an economic opinion), to withdraw the appeal, which was then stricken on August 2, 2006. The Company is preparing to file a new and revised application to the Antitrust Commissioner. In the opinion of the Company, the mobile telephony market is an alternative market for fixed-line telephony, and this fact is reinforced by new and up-to-date data which has accumulated during the period since the appeal was filed in 2001.
- (3) Further to Note 1E(1)a. to the financial statements as at December 31, 2005, concerning revision of the Company's tariffs – on July 1, 2006 the Communications Regulations (Telecommunications and broadcasts) (Payment for telecommunications services), 5766-2006 and the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunications services and their linkage) (Amendment No. 2), 5766-2006, came into effect. According to the regulations and based on the tariff update formula prescribed in the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunications services and their linkage), 5763-2003, the average reduction of the controlled tariffs of the Company determined according to Section 15(a) of the Communications Law, applicable from July 1, 2006, is 0.36% (excluding the reduction of VAT by 1% which took effect on the same date). This reduction is based on a change of about 2.4% in the Consumer Price Index, less an average efficiency factor of about 2.7%. In addition, the Communications Regulations (Telecommunications and broadcasts) (Payment for interconnect) (Amendment), 5766-2006, whereby interconnect fees were reduced by approximately 2% (including the 1% VAT reduction), came into effect on the same date.

Notes to the Financial Statements as at June 30, 2006

NOTE 1 – GENERAL (CONTD.)

- (4) Further to Note 1E(1)c. to the financial statements as at December 31, 2005, concerning regulations relating to proceedings and conditions for receipt of a special general license for providing fixed-line domestic communications services without a universal obligation – to the best of the Company's knowledge, during the first quarter of 2006 another two licenses were granted to two additional operators. The subsidiary Bezeq International Ltd. filed an application for such a license. Since the Ministry of Communications has not yet responded to the subsidiary's application for a general license, on July 25, 2006 the subsidiary filed an application for extension of the term of the marketing trial license for VOIP services which it was granted until August 31, 2006, until the date of the Ministry of Communications' decision on the matter of the general license.
- (5) Further to Note 1E(1)f. to the financial statements as at December 31, 2005, concerning a numbering plan for number portability registration – during February and March 2006, further correspondence with the Ministries of Communications and Finance concerned the inability of operators, including the Company, to comply with the timetables set. The Company repeated its notice that it is making its best efforts and investing extensive resources for the implementation of number portability but for pertinent technical reasons would not be able to meet the timetables set for implementation of the plan. The Company requested that the Minister take action for a legislative proceeding for amendment of the Communications Law so that a reasonable timetable would be prescribed for the implementation of number portability. On August 2, 2006 a letter was sent from the Supervisory Department at the Ministry of Communications, stating, among other things, that the Company's explanations regarding non-compliance with the timetables were unacceptable. On August 8, 2006, a letter was sent by the Company in response to that letter, in which it was clarified that the discussion summary did not correspond, in the Company's view, to the gist of the actual discussion, that the Ministry's strong positive impression of the Company's actions was not reflected in the summary, and that earlier preparation could not be commenced before a plan was formulated and because the Ministry of Communications had not formulated a full characterization. On August 7, 2006 the Chairman of the Number Portability Forum, who acts on behalf of the relevant operators, sent a letter to the Minister of Communications, requesting that the Minister take action for postponement of the date set for implementation of the plan..
- (6) Further to Note 1H to the financial statements as at December 31, 2005, concerning the resolution of the Board of Directors of the Company on March 1, 2006 to recommend to the General Meeting of the shareholders of the Company the distribution of a cash dividend to the shareholders in the amount of NIS 1,200,000,193, which as at the date of the distribution constitutes NIS 0.4606446 per share – the Special General Meeting of the shareholders of the Company which convened on March 23, 2006, approved the distribution of the dividend. The dividend was distributed on April 16, 2006.
- (7) The Ministry of Communications notified the Company on May 9, 2006 of its intention to call in a guarantee of NIS 7 million out of the bank guarantee of \$10 million which the Company deposited for securing fulfillment of the terms of its license, due to its position that the Company launched a campaign in a way which deviates from the rules of the regulation applicable to campaigns. The position of the Company is that it does not require the approval of the Ministry for marketing campaigns. The Company intends to exhaust every legal avenue open to it on this matter, and its first step, taken on May 24, 2006, was to appeal the Minister's decision. The appeal has been heard but no decision has yet been made. The financial statements do not include a provision in respect of this matter.
- (8) In May 2006 the Company received a letter from the Antitrust Authority concerning complaints of certain communications operators of actions ostensibly being taken by the Company against those operators and a complaint of one of the operators which was received from the Ministry of Communications. According to the operators, the actions constitute abuse of the Company's monopolistic power. The Company was requested to submit to the Authority and to the Ministry both data and answers to questions in the letter, and has done so.

Notes to the Financial Statements as at June 30, 2006

NOTE 1 – GENERAL (CONTD.)

- (9) On May 23, 2006 investigators from the Antitrust Authority appeared at the Company's offices and presented an order from the Magistrate's Court permitting them to search the Company's offices and seize any document or object required for their investigation. According to the order, the cause for grant of the order was suspicion of abuse of monopoly status according to Section 29A of the Antitrust Law together with Section 47(A)(4a) of that law and/or unreasonable refusal to provide a monopoly asset or service according to Section 29 of the Antitrust Law. During the search, which has not yet ended, the investigators collected various documents, including computer material, and several employees were requested to accompany the investigators to the Antitrust Authority's offices for questioning. The Company is cooperating fully with the Authority's investigators. The investigation is still in progress, and accordingly, the Company, relying on its external legal adviser who is handling the case on its behalf, is unable, at this stage, to estimate the outcome and implications of the investigation, including the possibility of indictments being filed and/or civil proceedings being instituted against the Company.
- (10) Further to Note 1E(2)a. to the financial statements as at December 31, 2005, concerning the decision of the Minister of Communications to oblige the Company to transfer to Cellcom interconnect payments according to actual traffic – a settlement agreement was signed between the Company and Cellcom, under which the Company paid Cellcom the agreed amount. There is no effect on the financial statements of the Company for the reported period, due to a provision recorded in the Company's books in the past.
- (11) Further to Note 9F to the financial statements as at December 31, 2005, the negotiations with the foreign investor for the sale of the Company's satellite operations failed to lead to an agreement. The Company has commenced negotiations with other potential investors.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. GENERAL

The significant accounting policies applied in these financial statements are consistent with those applied in the annual financial statements, except as stated in this Note.

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS

(1) Accounting Standard No. 20 (Amended) – Accounting treatment of goodwill and intangible assets in the acquisition of an investee company

Commencing January 1, 2006, the Company has applied Accounting Standard No. 20 (Amended) ("the Standard") of the IASB. The Standard prescribes the accounting treatment for goodwill and intangible assets upon acquisition of a subsidiary and of an investee company which is not a subsidiary, including a company under joint control.

The principal changes set out in the Standard as compared with the principles applied in the past are: attribution of the surplus cost of the acquisition of investment in an investee company also to identifiable intangible assets of the acquired company; a distinction between intangible assets having a defined useful life and intangible assets of an indefinite useful life; immediate recognition as gain, on the date of acquisition, in the statement of income, of negative goodwill created in the acquisition after deduction of intangible assets and non-financial assets of the investee company; termination of the systematic deduction of positive goodwill and intangible assets with an indefinite useful life; distinction between goodwill of a subsidiary and of an investee company which is not a subsidiary for the matter of impairment. Comparative figures were not restated.

The amounts of amortization of goodwill, the deduction of which was terminated on January 1, 2006, in the six-month and three-month periods ended June 30, 2005 and in the year 2005, were NIS 46,559,000, NIS 23,279,000 and NIS 93,112,000, respectively (see also Note 10).

Notes to the Financial Statements as at June 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS (CONTD.)

(2) Accounting Standard No. 21 – Earnings per share

Commencing January 1, 2006, the Company has applied Accounting Standard No. 21 (Amended) ("the Standard") of the IASB. Pursuant to the Standard, the Company computes the basic earnings per share with regard to profit or loss, as well as the basic earnings per share with regard to profit or loss from ongoing operations, attributed to the ordinary shareholders. The basic earnings per share is calculated by dividing the profit or loss attributed to the ordinary shareholders, by the weighted average of the number of ordinary shares in circulation during the period.

For the purpose of calculating diluted earnings per share, the Company adjusted the profit or the loss attributed to the ordinary shareholders, and the weighted average of the number of ordinary shares in circulation, in respect of the effects of all the diluted potential ordinary shares. The Company's equity in the earnings of investee companies was computed according to its equity in the earnings per share of those companies, multiplied by the number of shares the Company holds. The initial application of the Standard did not affect the earnings per share of the Company.

(3) Accounting Standard No. 22 – Financial instruments: disclosure and presentation

Commencing January 1, 2006, the Company has applied Accounting Standard No. 22 ("the Standard") of the IASB. The Standard sets out the rules for stating financial instruments in the financial statements and details the proper disclosure required for them. In addition, the Standard determines the manner of classification of financial instruments as financial liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which financial assets and financial liabilities should be set off. The Standard cancels Opinion 53 – Accounting treatment of convertible liabilities, and Opinion 48 – Accounting treatment of option warrants. The Standard was adopted on a prospective basis. Comparison figures relating to prior periods were not restated.

Following the first-time adoption of the Standard, the Company set off deferred issuance expenses of approximately NIS 9 million from the debenture and loan items.

(4) Accounting Standard No. 24 – Share-based payment

Commencing January 1, 2006, the Company has applied Accounting Standard No. 24 ("the Standard") of the IASB. Pursuant to the provisions of the Standard, the Company will recognize share-based payment transactions in its financial statements including transactions with employees or other parties that must be settled in equity instruments, in cash or by other assets. Share-based payment transactions in which goods or services are received will be reported at their fair value.

Regarding transactions which are settled in capital instruments, the Standard applies to grants made after March 15, 2005 but which had not yet vested by January 1, 2006. In the same manner, the Standard applies to changes which occurred in the terms of the transactions settled in capital instruments which were made after March 15, 2005, even if the grants in respect of which the changes were made were prior to that date. The first-time application of the Standard did not affect the results of operations and the financial condition of the Group.

Notes to the Financial Statements as at June 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS (CONTD.)

(5) Accounting Standard No. 25 – Income

Commencing January 1, 2006, the Company has applied Accounting Standard No. 25 ("the Standard") of the IASB. The Standard deals with recognition of income from three types of transactions: the sale of goods, the provision of services, and the use made by others of the company's interest-yielding assets, royalties and dividends, and it prescribes the accounting treatment required (rules of recognition, measurement and disclosure) for those three types of transaction. The initial application of the Standard did not affect the results of operations and the financial condition of the Group.

As of January 1, 2006, the Company has applied the IASB published Clarification No. 8 – "Reporting income on a gross basis or a net basis" ("the Clarification"). The Clarification is based on the professional publication EITF 99-19 of the Emerging Issues Task Force in the USA. According to the Clarification, an entity operating as an agency or as a broker without bearing the risks and yields deriving from the transaction, will state its income on a net basis. Conversely, an entity operating as a principal supplier and bearing the risks and yields deriving from the transaction, will state its income on a gross basis. The Clarification provides a list of indicators to be considered in order to determine the basis on which income should be reported – gross or net. Since in the past the Company treated the matter of gross or net income in accordance with the provisions of EITF 99-19, the first-time application of the new Clarification had no material effect on the Company.

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

Accounting Standard No. 29 – Adoption of international financial reporting (IFRS)

In July 2006 the IASB published Accounting Standard No, 29 - Adoption of international financial reporting standards (IFRS) ("the Standard"). The Standard states that entities subject to the Securities Law, 5728-1968 and required to report in accordance with the regulations of that law, will prepare their financial statements according to IFRS standards for periods commencing January 1, 2008. The Standard enables earlier adoption, from the financial statements which will be published after July 31, 2006. The IFRS standards will be adopted for the first time together with application of the provisions of IFRS Standard 1 – First-time Adoption of IFRS Standards, for the purpose of the transition. The Company is examining the effects of the Standard on its financial statements, including the possibility of early application of the IFRS standards.

D. RESTATEMENT

Further to Note 2(FF) to the financial statements as at December 31, 2005, the financial statements as at June 30, 2005 and December 31, 2005 were adjusted retroactively by way of restatement in order to reflect the recording of a liability of the Company to its retirees, as shown below:

(1) Effect on the Consolidated Balance Sheet as at June 30, 2005

	<u>As previously reported</u>	<u>Effect of restatement</u>	<u>As reported in these financial statements</u>
	<u>NIS thousands</u>	<u>NIS thousands</u>	<u>NIS thousands</u>
Current liabilities	4,377,432	10,000	4,387,432
Long-term liabilities	8,234,911	134,000	8,368,911
Shareholders' equity	7,909,777	(144,000)	7,765,777

Notes to the Financial Statements as at June 30, 2006

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

D. RESTATEMENT (CONTD.)

(2) Effect on the Consolidated Balance Sheet as at December 31, 2005

	As previously reported	Effect of restatement	As reported in these financial statements
	NIS thousands	NIS thousands	NIS thousands
Current liabilities	5,221,488	10,000	5,231,488
Long-term liabilities	7,386,524	134,000	7,520,524
Shareholders' equity	8,057,860	(144,000)	7,913,860

(3) Effect on Retained Earnings (Deficit)

	As at March 31 2006	As at June 30 2005	As at March 31 2005	As at December 31 2005	As at December 31 2004
	NIS thousands				
As previously reported	(888,194)	(60,554)	(224,857)	(1,113,706)	(504,564)
Effect of restatement	(144,000)	(144,000)	(144,000)	(144,000)	(144,000)
As reported in these financial statements	(1,032,194)	(204,554)	(368,857)	(1,257,706)	(648,564)

The effect of the amendment on the statement of operations in the reported periods is marginal.

NOTE 3 – RATES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES

The changes that occurred in the consumer price index and in the exchange rates of the US dollar and the euro in the period of account, are as follows:

	Consumer price index	Exchange rate of the US dollar	Exchange rate of the euro
	%	%	%
For the six-month period ended:			
June 30, 2006	1.55	(3.54)	3.62
June 30, 2005	(0.50)	6.17	0.50
For the three-month period ended:			
June 30, 2006	0.96	(4.82)	(0.33)
June 30, 2005	1.17	4.88	1.10
For the year ended December 31, 2005	2.39	6.85	(7.33)

Notes to the Financial Statements as at June 30, 2006

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS")

In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, and commenced provision of services in July 2000. Since starting operations, DBS has accumulated considerable losses. The loss for 2005 amounted to approximately NIS 328 million and the loss for the six-month period ended June 30, 2006 amounted to approximately NIS 140 million. As a result of these losses, DBS's capital deficit and working capital deficit as at June 30, 2006 amounted to approximately NIS 3,734 million and NIS 546 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,562 million (before interest and linkage). The Company's equity in the accumulated losses of DBS since its investment (excluding deduction of goodwill) is approximately NIS 1,707 million, of which approximately NIS 132 million was recorded in the six-month period ended June 30, 2006 (DBS's losses for the period, net of the increase in new loans given by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 100 million. This debt has not yet been repaid, even though the due date for most of the amount has passed and the Company is working with DBS on its collection.

The terms of the long-term loans which DBS received from banks, the balance of which as at June 30, 2006 is NIS 1,328 million (including current maturities), impose various restrictions on DBS, which include, *inter alia* – restrictions relating to encumbrance or sale of certain assets, restrictions on receipt of credit from other banks without prior approval, a restriction on repayment of shareholders loans, and a demand to comply with financial criteria ("the Conditions"). As at June 30, 2006, DBS is in compliance with the Conditions prescribed in the financing agreements (after a benefit which was granted in connection with the financial criteria in respect of the second quarter of 2006). In view of the projections of the Management of DBS regarding its business results for the coming years, DBS is working with the banks to revise the financial directives in the financing agreement. DBS is also negotiating with the banks to settle a dispute relating to insurance obligations prescribed in the financing agreement.

In March 2006, Israel Aircraft Industries ("IAI") demanded that DBS clear its entire debt to IAI, following DBS's failure to make the payments prescribed in the payment arrangement between the parties. As at the date of approval of the financials statements, DBS is in discussions with IAI for a solution that will be satisfactory to the parties. The failure to comply with the payment arrangements constitutes a violation event under the financing agreement with the banks. Following IAI's demand, DBS reported the event to the banks. On May 14, 2006 a letter was received from the banks in which they confirm that they will not see IAI's demand as a breach by DBS of the amended financing agreement, provided that by August 1, 2006, the parties arrive at a written arrangement with IAI for repayment of the aforementioned debt to IAI and provided that during the period up to August 1, 2006 inclusive, IAI does not take any steps for collecting that debt. As at the date of approval of these financial statements, DBS had received another letter from the banks, extending the period in which DBS can arrive at a written arrangement with IAI to December 31, 2006.

In March 2004, the Board of Directors of the Company approved an additional investment of NIS 440 million in DBS by the end of 2005 ("the Additional Injection"), of which, by 11 October, 2005, the Company had transferred approximately NIS 284 million of the Additional Injection to DBS.

On December 31, 2004 and February 14, 2005, the Company and DBS were notified of decisions of the then Minister of Communications relating to the Additional Injection. Those decisions determined, *inter alia*, that –

- (1) The total amount of the planned Additional Injection (NIS 440 million) was limited to a maximum of NIS 350 million.
- (2) With regard to the NIS 195 million of the Additional Injection already transferred by the Company at that time to DBS, no additional action was taken.
- (3) The balance of the sum, a maximum of NIS 155 million, would be transferred once every quarter in equal portions during 2005.

Notes to the Financial Statements as at June 30, 2006

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (CONTD.)

- (4) The Company would not be permitted to provide a guarantee to the shareholders of DBS, to banks or to institutional entities, or to make any other similar commitment, for securing their part in the Additional Injection or in credit granted to DBS by them.

In April and May 2005, the Company and DBS filed petitions in the High Court of Justice for grant of an order *nisi* against the Minister of Communications, declaring that the decisions described above are null and void. The petitions, which were heard on October 11, 2005, raised questions of principle which are far from simple, both factually and legally, which were brought into sharp focus during the hearing. The Court has not yet given its decision.

On March 21, 2006, the Company received a letter from the Minister of Communications, stating that after examining the implications of further injections of funds into DBS for the promotion and consolidation of competition in fixed-line domestic communications, and based on the business plans of DBS for 2006 which were presented to the Minister of Communications, according to which the injections needed in 2006 amount to NIS 55 million, the Minister of Communications is considering placing a limit on injections of funds in 2006 in the following manner:

- (1) The Company's part in the total injections into DBS would not exceed 40%.
- (2) The part of the other DBS shareholders and of the banks or financing institutions would not exceed 60%.
- (3) The Company or an entity acting on its behalf would not provide a guarantee to the shareholders, the banks or institutional financing entities, or any similar commitment, for securing their part in the injections or in credit granted by them to DBS.
- (4) Towards the end of 2006, the subject of the injections, insofar as required in future years, would be re-examined.

The Company sent its response to the letter on April 2, 2006, in which it gave notice that it opposes the decision being considered by the Ministry of Communications, which it believes to be *ultra vires*, and is requesting a hearing to explain its position and make its arguments orally before the Minister of Communications. As at the date of publication of these financial statements, the Company had not yet been invited to argue its position before the Minister.

On January 31, 2006 the Board of Directors of DBS approved its budget for 2006, which requires DBS to obtain additional external financing for the year. As at the date of approval of the financial statements, DBS is working to obtain additional financial resources which will enable it to achieve its targets for the coming year. If those resources cannot be obtained, DBS will operate in accordance with an alternative business plan which does not necessitate additional resources beyond those already existing. The Management of DBS believes, based on the 2006 budget and on the alternative business plan, that the prospects for arranging the financial resources required by DBS in the coming year are good.

On August 2, 2006 the Company and DBS filed merger notices to the Antitrust Commissioner ("the Commissioner"), concerning exercise of options for DBS shares by the Company, which would increase the percentage of the Company's holding in DBS from approximately 49.8% to approximately 58%. The Commissioner's approval for increase the Company holding in DBS to more than 50% has already been given (on certain conditions) in the past (on January 2, 2005), but expired one year later, and therefore the companies have submitted a renewed request for approval of the merger.

B. GOLDNET COMMUNICATION SERVICES, A REGISTERED PARTNERSHIP ("GOLDNET")

On April 30, 2006 an agreement was signed between the Company, Malam Systems Ltd. and Goldnet of the first part, and the subsidiary Bezeq International of the other part, for acquisition of all the operations of Goldnet by Bezeq International, in consideration of NIS 6.8 million, which will be divided between the Company (NIS 5.1 million) and Malam Systems (NIS 1.7 million).

Upon fulfillment of all the suspending terms prescribed in the acquisition agreement and payment of the consideration, Goldnet will cease to provide services.

Notes to the Financial Statements as at June 30, 2006

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

C. MERGER OF THE OPERATIONS OF BEZEQCALL COMMUNICATIONS LTD. AND BEZEQ INTERNATIONAL LTD.

After the balance sheet date, the Company began examining a possible merger of the operations of the wholly-owned subsidiary BezeqCall Communications Ltd. (whose business is in network end points) and the wholly-owned subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for businesses). Such a merger, if and to the extent accomplished, would require approvals prescribed in law, among them of competent entities, the Ministry of Communications and the Antitrust Commissioner.

In addition, after the balance sheet date, BezeqCall commenced negotiations for acquisition of another operation in its area of business. The scope of the transaction is estimated at approximately NIS 90 million. If the transaction is closed, it too will require approvals, among them the approvals of the competent organs of the parties.

NOTE 5 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

EARLY RETIREMENT PLAN

Further to Note 16D to the financial statements as at December 31, 2005 – the negotiations between the Company's Management and the Union in connection with a change in the organizational structure, retirement / layoff of employees and a new labor agreement, are at an advanced stage of drafting an agreement. The agreement will require the approval of the New General Federation of Workers ("the Histadrut") and the Board of Directors of the Company.

On April 27, 2006 the Company received a "Notice of strike action or work to rule" pursuant to the Resolution of Labor Disputes Law, 5717-1957 ("the Notice"). The Notice related to a strike at the Company from May 14, 2006 onwards, which was declared by the Histadrut and approved, according to the contents of the Notice, by the representative trade union.

The issues in dispute, according to the Notice, are as follows:

- "a. Serious foreseen implications for workers as a result of the severe damage to the strength of the Company due to the failure to arrange the matter of the grant of discounts, reduction of royalties of the Company, tariff flexibility and against a background of grant of licenses to competitors on terms which are extremely detrimental to the Company.
- b. Disregarding the workers' representation and its demands and bad faith and unacceptable conduct in collective labor relations in general and, in labor relations in public service, in particular."

Following serious disruptions and malfunctions caused by workers' sanctions, on May 18, 2006 the Company turned to the Labor Court. In the hearing, it was decided that the workers must return to work and intensive negotiations held for arriving at an agreed solution not by way of sanctions or strike.

Notes to the Financial Statements as at June 30, 2006

NOTE 6 – CONTINGENT LIABILITIES

A. CLAIMS AND CONTINGENT LIABILITIES

The Company and the investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 19A to the annual financial statements of the Company as at December 31, 2005 and published on March 1, 2006. No material changes in contingent liabilities have occurred up to the date of signing these financial statements, other than the following:

- (1) Further to Note 19A(4)(b) to the financial statements as at December 31, 2005 concerning different claims relating to recognition of various salary components as pension components and of the notice of a party to the collective dispute ("the Claim") which was filed by the New General Federation of Workers ("the Histadrut") in the name of all the employees of the Company, in which the Histadrut alleged that grossing up payments, the administrative on-call component and clothing allowances ("the Components") which were and are paid to Company employees, are regular pay which form part of the determining salary of every employee, including for the calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hourly pay value and that various payments and provisions should be made in respect thereof, including for pension purposes. On April 4, 2006 the decision of the Jerusalem Regional Labor Court dismissed the Claim and all its component parts filed by the Histadrut in the name of all Company employees.

In its decision, the Court allowed in full the argument of the Company, that the conduct of the parties over so many years indicates unequivocally that the demands of the Histadrut directly contradict the agreements applicable in the relations of the parties, which are binding in the circumstances, and therefore those demands should be dismissed. The Court further determined that even if the Components are examined on their merits, the Claim would be dismissed since according to case law, all three Components fall within the definition of "extras" and not "pay", and therefore do not grant entitlement to the reliefs claimed by the Histadrut.

Further to Note 19A(4)c. to the financial statements as at December 31, 2005, concerning the claim of a group of employees in the matter of including a number of components as part of the determining salary for pension, on August 6, 2006 a decision was given dismissing the claim and all its parts, and the court ruled that the salary increments are not fictitious extras but genuine and conditional increments and therefore are not part of the basic salary for the computation of the pension or of severance pay, vacation pay, sick pay, retirement grant and acclimatization grant. The decision is subject to a right of appeal by the plaintiffs.

The financial statements contain a provision of NIS 50 million in respect of the administrative on-call component and in respect of the Components claim. The Company has examined the significance and implications of the decision described above, and has concluded that the conditions are not yet ripe for canceling or reducing the provision or part of it.

- (2) Further to Note 19A(9) to the financial statements as at December 31, 2005 concerning a claim filed by a competing international communications operator against the Company and against Bezeq International in the amount of NIS 57 million, for a number of causes relating, *inter alia*, to postponement of implementation of the customer allocation proceeding, a mediation proceeding was commenced between the parties and is now in progress. The Company, relying on its legal advisers, believes that the chances of the claim being dismissed are greater than the chances of it being allowed. The management of Bezeq International believes, concerning the rationale that its part in the amount of the claim is approximately NIS 29 million and the estimation of its legal advisers that there is a reasonable but not definite chance that Bezeq International will be ordered to pay some part of that amount, that Bezeq International will not sustain material loss beyond the amounts included in the financial statements.

Notes to the Financial Statements as at June 30, 2006

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (3) Further to Note 19A(11) to the financial statements as at December 31, 2005 concerning a claim and application for recognition as a class action, in the matter of reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard – on April 16, 2006 the applicant filed an application to amend the application for recognition as a class action pursuant to the new Class Actions Law, 5766-2006. The Company opposed the application. The Court has not yet given its decision. In the opinion of the legal advisers who are handling the claim on behalf of the Company, against a background of developments and the possibility that the court will allow the applicants to amend their claim following amendment of the Telecommunications Regulations, the chances that the claim will prevail cannot be assessed at this stage.
- (4) Further to Note 19A(14) to the financial statements as at December 31, 2005 concerning the dismissal of a class action filed against the Company in May 2003, alleging that the Company abuses its monopolistic power and collects enormous sums of money from internet users in that it refuses to install splitters on high-speed (ADSL) lines – on March 27, 2006 the plaintiff filed an appeal in the Supreme Court, in which he petitions for the decision of the District Court dismissing his claim, to be cancelled. The Company believes, based on the opinion of its external legal advisers, that the chances of the appeal being allowed are lower than the chances of its dismissal, and accordingly, no provision was included in the financial statements in respect of this claim.
- (5) Further to Note 19A(16) to the financial statements as at December 31, 2005 concerning an action for declaratory relief filed in the Regional Labor Court by the Organization of Bezeq Retirees and six Company retirees against the Makefet Fund, the State of Israel and the Company, alleging breach of agreements for binding arrangements which were made at the time when the employees transferred from the civil service to the Company – in the decision on the application for dismissal *in limine* which was filed by the Company, the court decided not to strike out the Organization as a plaintiff and effectively put an end to the claim against Makefet. Regarding the claim against the Company and the State, the court directed that an amended statement of claim be filed, which has been done, and the Company is now required to respond with a statement of defense.
- (6) Further to Note 19A(20) to the financial statements as at December 31, 2005 concerning the dispute between the Company and the Ministry of Communications relating to the payment of royalties in respect of revenues for interconnection from cellular subscribers to Company subscribers, the Company reached an agreement with the Ministry for ending past disputes concerning royalties up to and including 2002, except for two negligible revenue components. As part of this agreement, the Company paid the sum of approximately NIS 17 million to the Ministry. In the past, the Company's financial statements included a provision for royalties which, in view of the agreement with the Ministry of Communications, is superfluous. Accordingly, the royalty expenses to the Government of Israel were reduced in the quarter by approximately NIS 36 million, and financing expenses in respect of the royalties were reduced by approximate NIS 31 million. The financial statements still contain a provision for possible disputes commencing from 2003, which the Company's Management believes to be appropriate.
- (7) On April 6, 2006 the Company received a claim together with an application for recognition as a class action, which was filed by a private (and inactive) company which is a subscriber of the Company. According to its allegations, the claim concerns the plaintiff being subscribed for the "Free From 7" track and being debited according to that track tariff, without having ordered the service. According to the plaintiff, it has cause of claim in the circumstances of the matter, under the Consumer Protection Law, 5741-1981, the Contracts Law (General part), 5733-1973, and the Unjust Enrichment Law, 5739-1979. The amount of the personal claim is assessed by the plaintiff at NIS 239.18.

Notes to the Financial Statements as at June 30, 2006

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(7) (contd.)

The plaintiff has applied for the claim to be recognised as a class action in the name of all the subscribers who were debited unlawfully in debit tracks and for certain services of the Company which are listed in the claim. The plaintiff estimates that the financial loss of the members of the group included in the class action could reach millions of shekels per year. The Company filed an application for the claim to be struck *in limine*, and the date for the Company's response to the claim has been postponed until a decision is made on its application (which has not yet been given). Relying on its legal advisers, the Company is unable, at this stage, to estimate the prospects of the claim.

- (8) On May 15, 2006, the Company received a claim with an application for recognition as a class action, which was filed pursuant to Section 5 of the Class Actions Law, 5766-2006. The Statement of Claim alleges that the Company collected from the plaintiff arrearage interest on amounts of value added tax which the plaintiff should have paid to the Company and which are not part of the services provided by the Company. The amount of the plaintiff's personal claim is NIS 0.33. The plaintiff does not make any assessment of the amount of the class action. The Company is studying the claim and is unable, at this stage, to estimate its prospects.
- (9) On May 25, 2006 a claim was filed in the Tel Aviv District Court together with an application for recognition as a class action under the Consumer Protection Law and the Class Action Law, alleging deception in advertising in the matter of a charge for calls from a Bezeq line to a cellular line. According to the plaintiff, the Company deceived the public in its advertisements, which stated that the price of a call from a Bezeq line to a cellular line would be "approximately 44 agorot per minute", whereas the exact price per call minute was 44.57 agorot, nor did it disclose that the charge for interconnect was made according to segments of 12 seconds, which means that the actual average charge was 49 agorot per minute. The plaintiff estimates the amount of the claim at approximately NIS 68.5 million (the amount of the personal claim is NIS 11). The Company is unable, at this stage, based on the lawyer who is handling the claim on his behalf, to estimate the chances of the application for approval.
- (10) Various municipalities and local councils have submitted demands to the Company for retroactive payment of municipal taxes in respect of an increase in the areas of buildings and changes in classification for municipal tax purposes. These claims amount to approximately NIS 55 million. The financial statements include a provision which the Company's Management, relying on the legal advisers who are handling the claims for it, considers appropriate.
- (11) On May 18, 2006, a claim was filed in the Tel Aviv District Court together with an application for recognition as a class action against the cable companies and against the Company. According to the plaintiff, on May 17, 2006 a fault occurred in his telephone line in the HOT network and it is possible that Company employees (who were imposing sanctions at that time) played some part in the malfunction. The plaintiff alleges that as a result of the malfunction, he incurred financial damages, harm to his goodwill and distress. The amount of the claim is estimated by the plaintiff at approximately NIS 100 million (the amount of the personal claim is assessed at about NIS 1,000). On July 16, 2006, the Company filed an application for dismissal *in limine* of the application for approval, arguing that the claim cannot be filed as a class action since it is not among the types of claims defined in the Class Actions Law and there are no provisions in any other law by virtue of which the claim can be filed. Accordingly, the date for filing the Company's response to the application for approval was postponed until a decision is given on the application for dismissal. Relying on its legal advisers, the Company is unable, at this stage, to assess the chances of the application for approval.
- (12) Further to Note 19A(34) to the financial statements as at December 31, 2005 concerning notice of the filing of an application to add Pelephone to an appeal proceeding filed by the owners of rights in land adjoining a cellular communication site operated by Pelephone together with others in Ramat Gan, Pelephone's objection to joining the proceeding as a whole was allowed. Pelephone believes, relying on its legal advisers at this stage of the proceeding, that it is at no risk of exposure.

Notes to the Financial Statements as at June 30, 2006

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

- (13) A number of proceedings were recently submitted to Pelephone, in which local committees were requested to add Pelephone as a party to various appeals filed in appeals committees against dismissal of claims of impairment of value under Section 197 of the Planning and Construction Law, in respect of the erection of communications installations. Pelephone is studying each application on its merits and making its decisions accordingly. Pelephone believes, relying on its legal advisers, that it is not at risk of material exposure at this stage of these proceedings.
- (14) A number of legal proceedings are in progress against Pelephone (whether in administrative petitions, appeals or civil actions), which were filed against the licensing and/or erection of communications sites. Pelephone, the respondent in these proceedings, opposes the applied for reliefs. Pelephone believes, relying on its legal advisers, that it is not at risk of material exposure in these proceedings.
- (15) On July 12, 2006 a claim was filed against Pelephone in the District Court, together with an application for recognition as a class action, in the amount of approximately NIS 251 million. The claim relates to the interpretation of the agreement with Pelephone signed by the plaintiff, concerning the reimbursement of payments he was charged by Cellcom when he switched from Cellcom to Pelephone. According to the plaintiff, Pelephone should have paid NIS 3,000 in respect of those payments, even though he did not comply with the terms of the agreement. At this stage, Pelephone is unable to assess the chances or the implications of the action.
- (16) On August 10, 2006, an application for approval as a class action was received by Pelephone, which was filed against Pelephone, Cellcom, and Partner. The amount of the action (consolidated against all three companies) is NIS 100 million (no separate amount was attributed to Pelephone). The action relates to the time of disconnection of calls made from a cellular network to the Company's network, an alleges that in such a call, where the Company customer initiates its termination, a surplus charge is applied until the actual disconnection of the call. At this stage, Pelephone is unable to assess the prospects and implications of the action. Pelephone is studying the claim and will respond as necessary.
- (17) Further to Note 19A(25) to the financial statements as at December 31, 2005 concerning a claim filed against Bezeq International by a supplier of a system in the amount of approximately NIS 18.5 million, for enforcement of an agreement for the delivery and installation of a customer relations management and billing system, following a mediation proceeding between the parties a settlement was reached for the mutual clearance of the claims in the case, against payment of a non-material sum by Bezeq International to the plaintiff. On June 19, 2006 the court validated the settlement agreement and instructed that the court fees paid by the parties be returned to them in full.
- (18) On June 14, 2006 an application was filed in the Tel Aviv District Court for approval of a claim as a class action against DBS and against the cable companies in connection with the broadcasting of advertisements during World Cup games ("the Application for Approval"). According to the applicants, the broadcasting of advertisements which they allege were integrated into the first three days of broadcasts on the World Cup channel as part of the games and the World Cup studio, was against the law, contrary to the contract between DBS and its customers and contrary to the terms laid down in the decision of the Council to approve the broadcasting of the 2006 World Cup games. The Applicants estimated the amount of the claim at NIS 530 for each subscriber who purchased the World Cup package, and in total – approximately NIS 106 million for all the members of the group (based on 200,000 World Cup subscribers from the cable companies and DBS together). The Applicants wish to sue DBS on the basis of the Class Actions Law, 5766-2006 by cause of deception, violation of a legislated duty, unjust enrichment and breach of a contractual undertaking, in respect of three damages categories: impairment of the value of the World Cup package, harm to autonomy, and causing distress. The response of DBS to the application for approval of the claim as a class action must be filed in the court by September 15, 2006. DBS, relying on its legal advisers, is unable to assess the chances of the claim at this preliminary stage.

Notes to the Financial Statements as at June 30, 2006

NOTE 6 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(19) For the provisions of their services, the Company and the subsidiary Pelephone operate installations which emit electromagnetic radiation. The operation of such installations is subject to the Non-ionizing Radiation Law, 5766-2006, most of whose provisions will come into force on January 1, 2007 ("the Radiation Law"), and the Pharmacists Regulations (Radioactive elements and their products), 5740-1980, which regulate the erection and operation of installations and their supervision, including a demand for permits for that purpose. Erection and operation permits are granted by the Supervisor of Radiation at the Ministry for Protection of the Environment, and grant of an operator's license necessitates presentation of a permit under the Planning and Construction Law. The Company and Pelephone are at an advanced stage of preparation and adaptation of their installations for operation in accordance with the provisions. The Company is operating to obtain building permits, to the extent required, for its broadcasting installations, as well as working with the Ministry of the Interior and the Ministry for Protection of the Environment on the implementation of National Outline Plan 36B ("NOP 36B"), which deals with building permits, insofar as required, for large broadcasting installations. On July 19, 2006 the Company sent a letter to the Ministry for Protection of the Environment, requesting that the Radiation Law be amended so that the application of its provisions concerning the presentation of a permit according to the Planning and Construction Law be postponed for three years from the date on which NOP 36B take effect. The subject of electromagnetic radiation and its effects has not yet been thoroughly investigated in Israel or elsewhere. The Company and Pelephone are using their best efforts to meet the requirements of the Radiation Law, including concerning the permits required. Nevertheless, the Company and Pelephone are unable to assess whether the approvals will be received within the time prescribed in the Radiation Law, whether the Ministry for Protection of the Environment will accede to the Company's request to postpone the date for presentation of the permits, and what the aforementioned implications might be.

B. FORWARD TRANSACTIONS

Future Currency Transactions – Accounting Hedging Transactions

Consolidated

	<u>Currency purchased</u>	<u>Currency payable</u>	<u>Final repayment date</u>	<u>Amounts receivable</u>	<u>Amounts payable</u>
	<u>NIS millions</u>				
Forward contracts at predetermined exchange rate (excluding premium/discount)					
	Dollar	NIS	September 2006	222	232
	Euro	NIS	August 2007	1,710	1,736
	CPI-linked NIS	NIS	December 2010	1,115	1,146

Future Currency Transactions – Contracts not for Accounting Hedging Purposes

	<u>Purchased currency</u>	<u>Currency payable</u>	<u>Last repayment date</u>	<u>Scope of commitment</u>
	<u>NIS millions</u>			
Forward contracts at predetermined exchange rate (excluding premium/discount)				
	Dollar	Shekel	August 2006	457
	Index	Shekel	December 2006	50

Notes to the Financial Statements as at June 30, 2006

NOTE 7 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

- A.** Further to Note 27C to the financial statements as at December 31, 2005, on March 23, 2006 the general meeting of the shareholders of the Company approved the Company entering into an agreement with a company which will be owned and controlled by the shareholders of Ap.Sab.Ar. and will provide the Company with regular management and consultation services, including by means of serving directors and directors who will serve from time to time in the Company and/or in its subsidiaries, for US \$1.2 million per year. The term of the agreement is from October 11, 2005 the date of closing the purchase of 30% of the shares of the Company by Ap.Sab.Ar.) to December 31, 2008, unless one of the parties gives the other three months' notice of its wish to terminate it.
- B. BENEFITS FOR DIRECTORS AND CEO**
1. On May 15, 2006 the Audit Committee and the Board of Directors approved the terms of employment of the Chairman of the Board, and on June 21, 2006 the terms were approved by the general meeting. Below are the details of the terms of his employment:
 - a. The Chairman will be employed at an 80% position under a personal employment agreement, at a monthly salary of NIS 150,000 and standard social benefits (senior employees insurance, supplementary study fund, company car, driver, expense account, telephone, etc.).
 - b. In addition to his regular monthly salary, a once yearly payment (with no accompanying conditions of any kind) in the amount of one million two hundred thousand shekels (linked to the Consumer Price Index).
 - c. The commitment will be for an undefined period, where each party has the right to bring the commitment to an end by giving three months' notice.
 - d. Insofar as the Company has an employee stock options plan, the Chairman will be included in it in accordance with the criteria of that plan.
 2. On August 14, 2006 the Board of Directors of the Company approved the sale of a real estate asset of the Company to the CEO of the Company (through a company in his control), for \$630,000 plus VAT. The consideration was set according to the valuation of an external appraiser and after no higher offer was received from other bidders.
- C.** Further to Note 27B to the financial statements of the Company as at December 31, 2005, concerning the new commercial agreement signed between the Company and the Ministry of Defense on behalf of the State of Israel for the provision of communications services by the Company – as at the date of publication of these financial statements, no agreed alternative had been found for the agreement and the parties are in dispute as to the method of accounting until an agreement is achieved on the matter. The financial statements include revenue from the Ministry of Defense at the tariffs in the agreement from May 8, 2005, which is NIS 25 million lower than the tariffs under the agreement from July 2002 and approximately NIS 45 million lower than the Company's normal tariffs. Up to June 2006 the Ministry of Defense paid the Company according to the tariffs in the June 2002 agreement. On June 21, 2006 the Ministry of Defense notified the Company that for the reasons set out in the letter, it intends to pay the invoices in accordance with the principles of the agreement from May 8, 2005, that it would make a retroactive accounting and that the balance of the payment for 2006 would be paid accordingly.

Notes to the Financial Statements as at June 30, 2006

NOTE 8 – REVENUES FROM COMMUNICATION SERVICES

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services –					
Traffic	672,508	716,460	331,966	348,223	1,436,615
Fixed fees	1,300,307	1,267,564	650,507	643,194	2,559,559
	1,972,815	1,984,024	982,473	991,417	3,996,174
Cellular telephone	1,870,766	1,823,987	943,961	896,623	3,643,795
International communications and internet services	474,472	380,755	242,355	192,189	775,532
Multi-channel television	635,283	576,136	320,320	292,002	1,171,318
Installation and sale of equipment to subscribers and miscellaneous	564,239	609,156	269,609	294,949	1,246,947
	5,517,575	5,374,058	2,758,718	2,667,180	10,833,766
Other revenues	127,552	126,440	67,154	60,195	264,920
	5,645,127	5,500,498	2,825,872	2,727,375	11,098,686

NOTE 9 – OPERATING AND GENERAL EXPENSES

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and incidental expenses –					
Operations	899,792	875,475	444,441	441,541	1,794,458
General and administrative	359,891	326,697	187,815	164,254	684,290
Total salaries and related expenses	1,259,683	1,202,172	632,256	605,795	2,478,748
General expenses	570,364	613,743	279,031	314,229	1,209,169
Materials and spare parts	414,059	499,155	211,735	242,609	1,016,735
Consumption of content from satellite services	216,157	202,251	107,715	102,053	419,309
Cellular telephone expenses	512,936	477,642	256,177	223,121	991,066
Building maintenance	167,518	169,805	83,369	82,998	366,630
Services and maintenance by sub-contractors	214,994	210,637	100,693	104,876	422,416
International communications expenses	195,706	130,121	99,300	66,094	277,210
Vehicle maintenance expenses	91,961	81,164	46,559	41,078	181,385
Collection fees	25,273	24,755	12,945	12,682	49,196
	3,668,651	3,611,445	1,829,780	1,795,535	7,411,864
Less – salaries charged to investment in fixed assets	104,377	105,793	49,156	53,734	218,396
	3,564,274	3,505,652	1,780,624	1,741,801	7,193,468

Notes to the Financial Statements as at June 30, 2006

NOTE 10 – OTHER INCOME, NET

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Provision for employee severance benefits upon early retirement	-	83,000	-	90,000	83,000
Disposals of assets and impairment of value of fixed assets	-	-	-	-	(830)
Provision for impairment and other liabilities in respect of the value of investments in other companies	(7,147)	(4,700)	(7,147)	(4,700)	(5,868)
Compensation in respect of a settlement agreement	-	14,483	-	-	14,483
Amortization of goodwill	-	(46,559)	-	(23,279)	(93,112)
Capital gain from sale of operation	-	103,869	-	2,009	103,869
Dividend (1)	26,010	-	26,010	-	-
Capital gains, net	12,187	2,749	2,611	1,019	5,715
Others	-	(100)	194	79	2,129
	31,050	152,742	21,668	65,128	109,386

(1) On May 14, 2006 the Company received the notice of Eurofund 2000 Partnership, a venture capital fund which invests mainly in start-ups in communications, software, internet, semiconductors and homeland security ("the Fund"), of a distribution, following the sale of the Fund's holdings (approximately 18%) in an optical network equipment company for approximately US \$42 million (the Fund had invested \$2 million in the company). As a result of the distribution, the Company recorded a capital gain of approximately NIS 26 million.

Notes to the Financial Statements as at June 30, 2006

NOTE 11 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. STATEMENTS OF OPERATIONS

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues (Note 11B)	2,331,700	2,355,190	1,160,991	1,159,472	4,723,734
Costs and expenses					
Operating and general expenses (Note 11C)	1,168,596	1,129,235	592,003	567,231	2,346,451
Depreciation	643,205	700,478	319,800	351,083	1,390,435
Royalties to the Government of Israel*	25,165	70,106	(5,855)	34,720	135,575
	1,836,966	1,899,819	905,948	953,034	3,872,461
Operating income	494,734	455,371	255,043	206,438	851,273
Financing expenses, net	25,224	31,023	7,022	25,096	80,897
Earnings after financing expenses	469,510	424,348	248,021	181,342	770,376
Other revenues, net	40,593	199,400	29,496	88,629	201,012
Earnings before income tax	510,103	623,748	277,517	269,971	971,388
Income tax	152,454	198,688	87,254	95,642	332,118
Earnings after income tax	357,649	425,060	190,263	174,329	639,270
Company's equity in earnings (losses) of investee companies	97,929	3,950	39,803	(10,026)	(63,412)
Earnings before the cumulative effect of change in accounting principle	455,578	429,010	230,066	164,303	575,858
Cumulative effect of change in accounting principle as at the beginning of the year	–	15,000	–	–	15,000
Net earnings	455,578	444,010	230,066	164,303	590,858

* See Note 6A6.

Notes to the Financial Statements as at June 30, 2006

NOTE 11 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. REVENUES FROM TELECOMMUNICATIONS SERVICES

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Fixed-line domestic communications -					
Traffic	684,405	744,070	337,961	363,610	1,460,076
Fixed fees	1,214,087	1,190,425	607,467	604,531	2,404,970
Total revenues from fixed-line communications	1,898,492	1,934,495	945,428	968,141	3,865,046
Cellular telephone	185,904	185,466	93,041	92,806	370,706
International communications	58,175	53,978	28,916	25,459	109,207
Installation and sale of equipment to subscribers and miscellaneous	94,850	74,274	41,631	20,099	167,904
	2,237,421	2,248,213	1,109,016	1,106,505	4,512,863
Other revenues	94,279	106,977	51,975	52,967	210,871
	2,331,700	2,355,190	1,160,991	1,159,472	4,723,734

C. OPERATING AND GENERAL EXPENSES

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses –					
Operations	570,758	552,371	281,287	274,904	1,140,482
General and administrative	170,792	136,773	93,471	68,133	288,804
Total salaries and related expenses	741,550	689,144	374,758	343,037	1,429,286
General expenses	130,373	154,034	65,141	80,274	298,767
Materials and spare parts	42,279	38,375	24,054	17,485	97,294
Building maintenance	151,274	153,088	75,088	74,862	320,700
Services and maintenance by sub- contractors	94,184	102,987	45,675	52,846	195,820
International communications expenses	13,309	9,875	6,061	4,800	30,033
Vehicle maintenance expenses	66,888	57,407	33,428	28,977	128,961
Collection fees	18,731	18,238	9,423	9,441	36,735
	1,258,588	1,223,148	633,628	611,722	2,537,596
Less – salaries charged to investments in fixed assets	89,992	93,913	41,625	44,491	191,145
	1,168,596	1,129,235	592,003	567,231	2,346,451

Notes to the Financial Statements as at June 30, 2006

NOTE 12 – BUSINESS SEGMENTS

The Company and the investee companies operate in various segments of the communications sector. Data on activities by segment are stated according to the segments of operation of those companies.

	For the six-month period ended June 30, 2006 (unaudited)						Consolidated
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	
	NIS thousands						
Revenues							
Revenues from external sources	2,190,601	2,178,145	491,819	660,638	123,924	–	5,645,127
Inter-segment revenues	141,099	7,551	9,929	8,985	47,675	(215,239)	–
Total revenues	2,331,700	2,185,696	501,748	669,623	171,599	(215,239)	5,645,127
Segment results*	494,734	294,238	69,049	(17,033)	5,950	–	846,938

	For the six-month period ended June 30, 2005 (unaudited)						Consolidated
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	
	NIS thousands						
Revenues							
Revenues from external sources	2,220,879	2,204,227	392,789	576,136	106,467	–	5,500,498
Inter-segment revenues	134,311	7,565	9,754	8,797	60,817	(221,244)	–
Total revenues	2,355,190	2,211,792	402,543	584,933	167,284	(221,244)	5,500,498
Segment results*	455,371	254,320	42,884	(49,793)	576	–	703,358

	For the three-month period ended June 30, 2006 (unaudited)						Consolidated
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	
	NIS thousands						
Revenues							
Revenues from external sources	1,087,813	1,093,204	251,866	333,640	59,349	–	2,825,872
Inter-segment revenues	73,177	4,067	5,030	3,936	23,084	(109,294)	–
Total revenues	1,160,990	1,097,271	256,896	337,576	82,433	(109,294)	2,825,872
Segment results*	255,041	155,010	35,901	(3,198)	3,603	–	446,357

* Segment results do not include Other income (expenses), net, as stated in Note 10.

Notes to the Financial Statements as at June 30, 2006

NOTE 12 – BUSINESS SEGMENTS (CONTD.)

	For the three-month period ended June 30, 2005 (unaudited)						Consolidated
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	
	NIS thousands						
Revenues							
Revenues from external sources	1,088,439	1,097,947	198,977	291,742	50,270	–	2,727,375
Inter-segment revenues	71,033	3,524	4,395	4,529	33,571	(117,052)	–
Total revenues	1,159,472	1,101,471	203,372	296,271	83,841	(117,052)	2,727,375
Segment results*	206,438	133,051	22,367	(25,340)	629	–	337,145

	For the year ended December 31, 2005 (unaudited)						Consolidated
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	
	NIS thousands						
Revenues							
Revenues from external sources	4,457,189	4,413,421	795,176	1,200,865	232,035	–	11,098,686
Inter-segment revenues	266,545	14,854	21,488	20,997	104,511	(428,395)	–
Total revenues	4,723,734	4,428,275	816,664	1,221,862	336,546	(428,395)	11,098,686
Segment results*	851,273	466,165	97,978	(99,535)	1,197	–	1,317,078

* Segment results do not include Other income (expenses), net, as stated in Note 10.

Notes to the Financial Statements as at June 30, 2006

**NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD.**

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheets

	June 30 2006	June 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	1,683,464	1,632,512	1,881,982
Long-term trade receivables	326,422	321,600	338,281
Investment in investee companies	4,923	4,283	3,565
Deferred income tax	–	51,129	19,799
Fixed assets, net	2,847,106	3,061,145	3,009,219
Other assets	338,293	330,053	337,787
	5,200,208	5,400,722	5,590,633
Current liabilities	1,396,101	1,378,262	1,558,012
Long-term liabilities	1,545,146	1,750,652	1,666,193
Shareholders' equity	2,258,961	2,271,808	2,366,428
	5,200,208	5,400,722	5,590,633

Notes to the Financial Statements as at June 30, 2006

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. Statements of Operations

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from Telephone services, sales and services	2,185,695	2,211,792	1,097,271	1,101,471	4,428,277
Cost of Telephone services, sales and services	1,635,565	1,686,130	808,752	826,979	3,415,885
Gross profit	550,130	525,662	288,519	274,492	1,012,392
Sales and marketing expenses	201,051	215,172	101,821	110,192	432,808
General and administrative expenses	46,024	49,968	22,870	25,051	107,218
	247,075	265,140	124,691	135,243	540,026
Operating income	303,055	260,522	163,828	139,249	472,366
Financing expenses, net	(41,853)	(39,448)	(38,471)	(29,321)	(115,264)
Other expenses (income), net	2,185	(107)	778	(65)	(1,136)
Earnings before income tax	259,017	221,181	124,579	109,993	358,238
Income tax	66,484	72,995	29,356	36,393	113,333
Earnings after income tax	192,533	148,186	95,223	73,600	244,905
Company's equity in losses of an affiliate	–	6,408	–	2,904	8,507
Net earnings	192,533	141,778	95,223	70,696	236,398

Notes to the Financial Statements as at June 30, 2006

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD.

A. Balance sheets

	June 30 2006	June 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	159,374	137,105	154,567
Broadcasting rights, net	188,986	159,613	154,500
Fixed assets, net	994,963	1,078,155	1,047,994
	<u>1,343,323</u>	<u>1,374,873</u>	<u>1,357,061</u>
Current liabilities	705,402	604,918	613,379
Long-term liabilities	1,399,578	1,348,381	1,419,257
Loans from shareholders	2,971,867	2,764,591	2,893,024
Capital deficit	(3,733,524)	(3,343,017)	(3,568,599)
	<u>1,343,323</u>	<u>1,374,873</u>	<u>1,357,061</u>

B. Statements of Operations

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from DBS services	669,622	584,933	337,576	296,271	1,221,863
DBS operating expenses	575,653	523,797	286,959	267,382	1,089,835
Gross profit	<u>93,969</u>	61,136	<u>50,617</u>	28,889	132,028
Sales and marketing expenses	59,102	66,707	27,491	33,284	140,665
General and administrative expenses	45,529	37,990	22,919	17,846	77,055
	<u>104,631</u>	104,697	<u>50,410</u>	51,130	217,720
Operating income (loss)	<u>(10,662)</u>	(43,561)	<u>207</u>	(22,241)	(85,692)
Financing expenses, net	129,098	100,801	72,904	61,382	241,335
Other expenses, net	202	88	1	8	830
Net loss	<u>(139,962)</u>	<u>(144,450)</u>	<u>(72,698)</u>	<u>(83,631)</u>	<u>(327,857)</u>

Notes to the Financial Statements as at June 30, 2006

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. Balance sheets

	June 30 2006	June 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	259,405	285,371	366,078
Long-term investments and debit balances	37,150	28,194	28,702
Fixed assets	317,449	326,519	305,826
Other assets	21,880	16,522	23,625
	635,884	656,606	724,231
Current liabilities	249,987	220,766	401,126
Long-term liabilities	25,754	183,614	14,835
Shareholders' equity	360,143	252,226	308,270
	635,884	656,606	724,231

Notes to the Financial Statements as at June 30, 2006

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD.,
DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

B. Statements of Operations

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunication services	501,749	402,543	256,897	203,372	816,664
Operating expenses	326,828	266,472	165,852	133,637	530,806
Gross profit	174,921	136,071	91,045	69,735	285,858
Marketing, general and administrative expenses	105,873	93,187	55,145	47,368	193,297
Operating income	69,048	42,884	35,900	22,367	92,561
Financing income (expenses), net	523	(3,563)	(290)	(1,974)	(3,361)
Earnings after financing, net	69,571	39,321	35,610	20,393	89,200
Other income (expenses), net	(195)	46	11	(294)	1,377
Earnings before income tax	69,376	39,367	35,621	20,099	90,577
Tax benefit (Income tax)	(21,851)	9,978	(11,047)	3,200	15,226
Earnings after income tax	47,525	49,345	24,574	23,299	105,803
Company's equity in earnings of an affiliated company	4,013	1,297	2,389	1,093	4,583
Net earnings	51,538	50,642	26,963	24,392	110,386